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No. 87-2136

Supreme Court, U.S.
FILED
AUG 24 1988
JOSEPH E. SPANIOL, JR.
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1988

CITIZENS BANK OF CLOVIS, ET AL., PETITIONERS

v.

ANN D. MCLAUGHLIN, SECRETARY OF LABOR

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the district court properly enjoined petitioners, a bank and trustees of the bank's pension plan, from investing more than one-third of the plan's assets in one investment or type of investment, on the ground that petitioners had violated the diversification requirement of Section 404(a)(1)(C) of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. 1104(a)(1)(C).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A3) is reported at 841 F.2d 344. The opinion of the district court (Pet. App. A1) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on February 25, 1988. A petition for rehearing was denied on April 14, 1988 (Pet. App. A4). The petition for a writ of certiorari was filed on June 24, 1988. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In 1958, petitioner Citizens Bank of Clovis (Bank) established a pension plan (Plan) for its employees. Peti-

tioners Jeff Jacobs, Lynell G. Skarda, Oscar Toliver, and T. E. Willmon, Jr., are directors and officers of the Bank and trustees of the Plan. The Plan and its trustees are subject to the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. (& Supp. IV) 1001 *et seq.* Pet. App. A1, at 2. Among other requirements, ERISA imposes on trustees the fiduciary duty to "diversify[ ] the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so * * * " (§ 404(a)(1)(C) of ERISA, 29 U.S.C. 1104(a)(1)(C)).

In 1982, when this controversy began, petitioners had invested roughly 82% of the Plan's assets of $707,000 in real estate mortgages in Curry County, New Mexico, the area surrounding the City of Clovis (Pet. App. A1, at 3; Pet. App. A3, at 4). These mortgages, secured by commercial properties, were intermediate-term, fixed-rate loans (Pet. App. A1, at 15). Moreover, these mortgages did not "appear to be very liquid given their duration and the lack of an established secondary market for such unique loans" (*ibid.*).[1] Because of the substantial concentration of the Plan's assets in one type of investment, respondent Secretary of Labor (Secretary) filed this action against petitioners in the United States District Court for the District of New Mexico. The Secretary charged petitioners with violating, among other ERISA provisions, the diversification requirement set forth at Section 404(a)(1)(C) of ERISA, 29 U.S.C. 1104(a)(1)(C). Pet. App. A1, at 1-4.[2]

[1] By July 1983, when respondent Secretary of Labor filed this action, petitioners had reduced the concentration of the Plan's assets invested in such mortgages to 65.7%. By the time of trial in June 1985, petitioners had further reduced the concentration to 21%. Pet. App. A1, at 3.

[2] The Secretary, under Section 503(a)(2) and (5) of ERISA, 29 U.S.C. 1132(a)(2) and (5), has authority to file civil actions to enforce

2. The district court, after a two-day bench trial, held that petitioners, "under the facts of this case" (Pet. App. A1, at 4), had violated the diversification requirement of Section 404(a)(1)(C) of ERISA, 29 U.S.C. 1104(a)(1)(C).[3] Accordingly, the court enjoined petitioners from investing more than one-third of the Plan's assets in one investment

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compliance with ERISA and enjoin practices in violation of the statute.

The Secretary, based on other transactions, charged petitioners with lending money between the Plan and an interested party, in violation of Section 406(a)(1)(B) of ERISA, 29 U.S.C. 1106(a)(1)(B), and self-dealing, in violation of Sections 404(a)(1), 406(a)(1)(D), 406(b)(1), and 406(b)(2) of ERISA, 29 U.S.C. 1104(a)(1), 1106(a)(1)(D), 1106(b)(1), and 1106(b)(2). See Pet. App. A1, at 4. The district court concluded that certain loans from the Bank to the Plan violated Section 406(a)(1)(B) (Pet. App. A1, at 17-21); the court also concluded, however, that other loan transactions did not violate ERISA (Pet. App. A1, at 21-25). The court of appeals affirmed both of these holdings (Pet. App. A3, at 6-12). Those rulings are no longer at issue.

[3] Initially, the court rejected petitioners' argument that the Secretary's complaint was moot given petitioners' reducing, at the time of trial, the concentration of real estate mortgages to 21% of the Plan's assets. The court noted that petitioners "insist on a free hand in selecting investments for the plan," and thus concluded that "[g]iven the potential for recurrence, the controversy regarding diversification is not moot" (Pet. App. A1, at 5 (citing *Donovan* v. *Cunningham*, 716 F.2d 1455, 1461-1462 (5th Cir. 1983), cert. denied, 467 U.S. 1251 (1984)).

The court also rejected petitioners' contention that the Plan, as a defined benefit plan as opposed to a defined contribution plan, was not subject to the diversification requirement of Section 404(a)(1)(C). In a defined benefit plan, the sponsor contributes sufficient funds in order for the plan to provide a set level of benefits (29 U.S.C. 1002(35)); in a defined contribution plan, the sponsor contributes a fixed amount and the plan pays benefits based on that amount and the plan's investment performance (29 U.S.C. 1002 (34)). The court concluded that neither the broad language of Section 404(a)(1)(C) nor the legislative history supported any such distinction between plans. Pet. App. A1, at 5-6.

or type of investment (Pet. App. A1, at 17; Pet. App. A2, at 1-2).

Construing the diversification requirement in light of the underlying common law of trusts,[4] the court observed that "[t]he purpose of diversification is to 'distribute the risks of loss * * *, usually by limiting the proportion of total trust assets invested in any one stock or class of securities' " (Pet. App. A1, at 8 (quoting G. Bogert & G. Bogert, *The Law of Trusts and Trustees* § 612, at 18 (rev. 2d ed. 1980)). The court further concluded, based on the legislative history, that ERISA's "basic policy is one of diversification" (Pet. App. A1, at 10), but stated that "[t]he degree of concentration in any asset or in any particular type of asset which would violate ERISA is determined on an ad hoc basis" (Pet. App. A1, at 11).

Turning to the specific facts of the case, the court found that, at a minimum, the mortgages were subject to the risks of default and inflation. Although petitioners had tried to minimize the risk of default, they had not eliminated that risk because each mortgage was secured by real estate located in one geographic area. "In the event of a severe economic downturn in that area, repayment of the loans might be affected and the value of the security backing those loans might also decline. This is precisely the risk at [sic] which diversification in its most elementary form seeks to minimize" (Pet. App. A1, at 14-15). Moreover, the mortgages posed a risk of significant loss. As intermediate term, fixed-rate loans, the mortgages were "subject to the risk that the anticipated real rate of return would decline due to inflation * * * [and were not] very li-

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[4] The court noted that the statutory diversification requirement, rooted in the law of trusts, closely tracks the language of Section 228 of the Restatement (Second) of Trusts (1959) (Pet. App. A1, at 8 (citing *Eaves* v. *Penn*, 587 F.2d 453, 457 (10th Cir. 1978)).

quid given their duration and the lack of an established secondary market" (Pet. App. A1, at 15).

The court thus concluded that petitioners' "heavy concentration in real estate mortgages in a limited geographic area constituted a lack of diversification" and that petitioners had not met their burden of showing that the failure to diversify was prudent (Pet. App. A1, at 16). The court therefore enjoined petitioners from investing more than one-third of the Plan's assets in one investment or type of investment (Pet. App. A1, at 17; Pet. App. A2, at 1-2).

3. The court of appeals affirmed (Pet. App. A3, at 1-14). Adopting the district court's "lengthy and well-reasoned analysis," the court of appeals held that the district court's conclusions concerning petitioners' violation of ERISA's diversification requirement were "fully supported in the record" (Pet. App. A3, at 5, 6).[5]

ARGUMENT

The decision of the court of appeals is correct. It does not conflict with any decision of this Court or of any other court of appeals. Accordingly, review by this Court is not warranted.

1. Petitioners renew the contention (Pet. 9-22, 29-30) that neither Section 404(a)(1)(C) of ERISA, 29 U.S.C. 1104(a)(1)(C), nor the legislative history supports the court-imposed prohibition against investing more than one-third of the Plan's assets in the real estate mortgages. The statute requires a plan fiduciary to diversify "the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent

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[5] The court of appeals also agreed with the district court, see note 3, *supra*, that the issue was not moot (Pet. App. A3, at 7).

not to do so" (29 U.S.C. 1104(a)(1)(C)). The Conference Report explained that this provision generally prohibited investment in "one type of security or in various types of securities dependent upon the success of one enterprise or upon conditions in one locality, since the effect is to increase the risk of large losses." H.R. Conf. Rep. 93-1280, 93d Cong., 2d Sess. 304 (1974). Indeed, with regard to real estate investments, the Conference Report specifically warned that a fiduciary "should not invest a disproportionate amount * * * in mortgages in a particular district or on a particular class of property so that a decline in property values in that district or of that class might cause a large loss" (*ibid.*). Accordingly, the courts below correctly concluded that petitioners' concentrating the Plan's assets in one type of security, *i.e.*, mortgages on commercial real estate located in one geographic area, violated the diversification requirement of Section 404(a)(1)(C). See *Donovan* v. *Guaranty Nat'l Bank*, 4 Employee Benefits Cas. (BNA) 1686, 1689 (W.D.Va. 1983); *Donovan* v. *Mazzola*, 2 Employee Benefits Cas. (BNA) 2115, 2136 (N.D. Cal. 1981), aff'd on other grounds, 716 F.2d 1226 (9th Cir. 1983).[6]

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[6] Petitioners also assert (Pet. 9-10, 17-19) that the courts below effectively established a general rule of law prohibiting all pension funds from investing more than one-third of their assets in any given security or type of security. This claim is overstated and meritless. The district court plainly based its decision on "the facts of this case" (Pet. App. A1, at 4), and also made clear that "[t]he degree of concentration in any asset or in any particular type of asset which would violate ERISA is determined on an ad hoc basis" (*id.* at 11). Moreover, the district court held that petitioners had violated the diversification requirement only after petitioners were unable to show, under the circumstances at hand, that the lack of diversification was prudent (*id.* at 16). Accordingly, petitioners cannot escape the record showing that the decisions below rested on an application of the statutory diversification requirement to the particular facts of this case.

2. Petitioners also argue (Pet. 22-29) that the mortgages were in fact diversified because they were secured by different types of commercial properties located in different parts of the Clovis metropolitan area. Petitioners thus assert (*ibid.*) that they had invested prudently for that reason and for the additional reason that borrowers having substantial net worth stood behind the collateral. These factual assertions were rejected by the courts below. It has long been this Court's practice, absent extraordinary circumstances, not to disturb the concurrent factual findings by an appellate court and a trial court. See, *e.g.*, *Goodman* v. *Lukens Steel Co.*, No. 86-1626 (June 19, 1987), slip op. 7-8; *Graver Tank & Mfg.* v. *Linde Air Products Co.*, 336 U.S. 271, 275 (1949). There is no reason to depart from that practice in this case.[7]

3. Finally, petitioners contend (Pet. 30-35) that the district court abused its discretion in enjoining petitioners from investing the Plan's assets as they deem proper. Under Section 409(a) of ERISA, 29 U.S.C. 1109(a), the court enjoys the discretion to order equitable relief "as the court may deem appropriate." This discretion is broad because, as one court has observed, "[b]eneficiaries of ERISA funds are entitled to have a court issue 'appropriate equitable relief' to insure that the trustees of their funds are not relying on mere fortune to manage the assets of the funds. Courts must, upon the application of the

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[7] To be sure, the district court did not expressly address petitioners' contention regarding the borrowers' net worth. Nevertheless, the court effectively and properly disposed of that point by holding that, despite petitioners' efforts to minimize the risk of default, petitioners had still exposed the Plan unnecessarily to that risk and to the risk that inflation could reduce the return on their investments (Pet. App. A1, at 14). In other words, even if the borrowers remain fully solvent, the mortgages, which were not "very liquid" (*id.* at 15), could lose significant value as investments.

Secretary of Labor, use this equitable power to prevent imprudent conduct by trustees." *Brock* v. *Robbins,* 830 F.2d 640, 647-648 (7th Cir. 1987); see *Eaves* v. *Penn,* 587 F.2d 453, 462 (10th Cir. 1978). Here, petitioners violated ERISA's diversification requirement, "insist[ed] on a free hand in selecting investments" (Pet. App. A1, at 5), and refused to assure that this violation would not recur (Pet. App. A3, at 7). Under the circumstances, the district court properly enjoined petitioners from again investing more than one-third of the Plan's assets in one investment or type of investment.[8]

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[8] Petitioners suggest (Pet. 33) that the district court should have refrained from issuing an injunction because "[d]ollars do not constitute irreparable injury as there is an adequate remedy at law." Irreparable injury, however, need not be shown where the government, as authorized by statute, files an action for injunctive relief. *E.g., United States* v. *Odessa Union Warehouse Co-op,* 833 F.2d 172, 175 (9th Cir. 1987). Petitioners also complain that the injunction, by its terms, is "ridiculous overkill" (Pet. 30). The district court correctly included the fixed limitation in the injunction, not only to satisfy the specificity requirement of Fed. R. Civ. P. 65(d), but also to avoid unnecessary confusion and uncertainty regarding compliance. See, *e.g., Schmidt* v. *Lessard,* 414 U.S. 473, 476 (1974) (per curiam). Lastly, petitioners renew (Pet. 33) their suggestion of mootness. The courts below properly disposed of this argument because a cessation of violations, either before or after litigation, does not preclude the award of injunctive relief. See, *e.g., United States* v. *W. T. Grant Co.,* 345 U.S. 629, 633 (1953).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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AUGUST 1988

U.S. GOVERNMENT PRINTING OFFICE 1988—202 037 60620